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## SOME PROBLEMS OF CLASSIFICATION IN PUBLIC FINANCE.

UNDER the extreme influence of the historical movement in political and economic science, it frequently happens in original work that more attention is paid to the collection and mere presentation of material than to careful, thoughtful analysis. In certain quarters the notion seems to prevail that originality consists solely in digging out of some obscure hole a certain number of facts. Investigation of the sources is, no doubt, valuable and necessary, but it is a mere preliminary step; and the new facts learned are useful only when properly analyzed and explained, or when applied to the explanation of already known principles. One of the unfortunate consequences of the mistaken notion has been a tendency to belittle the importance of correct, logical, scientific classification. Careful analysis and correct classification are, however, the only means of turning any mass of knowledge into a science. It is therefore gratifying that attention has recently been directed to some of the difficult problems of classification in public finance.

In the *Quarterly Journal of Economics* for April, 1893, Professor Seligman published an article on "The Classification of Public Revenues," in which he argued strongly for a division of public revenues into four main classes: (1) prices, (2) fees, (3) special assessments and (4) taxes in the narrower sense of the term.<sup>1</sup> Two years later he saw fit to modify the original scheme by the division of the first category into two parts, distinguishing quasi-private prices from public prices. In his recently published *Essays in Taxation*<sup>2</sup> the views expressed in

<sup>1</sup> The principles upon which these divisions are made are somewhat the same as those suggested by Professor Cohn in his *Finanzwissenschaft*, pp. 118-126, on the basis of a previous analysis of expenditures, pp. 104-118; see especially the summary, pp. 117, 118.

<sup>2</sup> New York and London, 1895.

the second article<sup>1</sup> were restated and may now be regarded as his settled opinion.

The definitions proposed for these classes are as follows :

*A quasi-private price* is a voluntary payment made by an individual for a service or commodity sold by the government in the same way as a private individual would sell.

*A public price* is a payment made by an individual for a service or commodity sold by the government primarily for the special benefit of the individual, but secondarily in the interest of the community.

*A fee* is a payment to defray the cost of each recurring service undertaken by the government primarily in the public interest, but conferring a measurable special advantage on the fee-payer.

*A special assessment* is a payment made once and for all to defray the cost of a specific improvement to property undertaken in the public interest, and levied by the government in proportion to the particular benefit accruing to the property-owner.

*A tax* is a compulsory contribution from the person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred.

The main features of this proposed classification seem to be so simple and logical, and seem to recognize so clearly the operation of great historical tendencies, that their general usefulness to the student of public finance for all scientific purposes cannot be disputed. It would, therefore, be extremely desirable if they could be universally accepted.

Professor Bastable, however, in the second edition of his *Public Finance*,<sup>2</sup> refuses to accept the suggestion, and among other things denies (1) that there can be only one correct classification, and (2) that there is any necessity for distinguishing between fees and taxes.<sup>3</sup> Professor Bastable's first

<sup>1</sup> *Quarterly Journal of Economics*, April, 1895.

<sup>2</sup> See pp. 153-156.

<sup>3</sup> The points omitted are (a) the discussion of fines and (b) the objection to special assessments. The former is omitted because of the insignificance of the revenue from fines and penalties, which, while not warranting their omission from a larger work, permits us to omit them in a short article. The latter is omitted because Professor Bastable's criticism seems to be partly valid, as will be seen, and partly based on an entire misconception of the nature of these charges, which it would take too much space to explain here.

objection is to the assumption — which, although not definitely made by Professor Seligman, is yet implied in the criticism of older classifications — that there is but one correct or natural classification. Professor Bastable claims that the sole consideration in the choice of a classification in such subjects as “grammar, jurisprudence, legislation and finance” is convenience for the immediate purpose in hand. It does not seem that this objection is altogether valid. For some subordinate purpose, it is true, temporary convenience may warrant abandoning the strictly logical classification ; but there is a scientific or logical necessity for recognizing, whenever present, a direct line of development. In the study of organic life it is unscientific to intermingle the recent with the older species: it is equally unscientific in the study of legal institutions or economic life to confuse the old and the new, or to classify in such a way as to hide the connecting links between them. Comparative philology, historical jurisprudence and the science of finance have succeeded in establishing certain general principles of development, which are for them what the development of the species is for natural science. Any classification which ignores the sequence of this development, or which omits important and characteristic steps, cannot claim to be thorough and scientific ; and temporary convenience will not excuse the refusal to accept the results of a truly scientific analysis. When Professor Bastable claims that it would be inconvenient to split the complex revenues from such public enterprises as the post-office into prices, fees and taxes, because the parts would be distributed over several different parts of his work, he is making a plea which, if valid, denies the value of most scientific analysis. It has never been regarded as impracticable, for any such reason, to analyze the revenues of an agriculturist who is the recipient of rent, interest and wages in one income. In fact, scientific thought demands such analysis.

Professor Bastable makes an equally untenable contention when he urges as an objection to the term “fee” that it is not commonly used in the sense given it by Professor Seligman. Does not economic science abound with terms which have a

strictly scientific meaning, different from that in common use? Take, for example, the fundamental terms value, rent, wages — in fact, almost any of the economic terms. A word adopted from daily life by science must be deprived of some of its “extension” for the purpose of giving it a perfectly clear “intension.” Even if we concede to Professor Bastable that this term is not altogether satisfactory for expressing the idea intended to be conveyed, we must insist that classification is something more than terminology. What concerns us is the idea as defined.

Let us, then, inquire whether the conception of fees, as defined by Professor Seligman, is of such a character that the failure to recognize it in a scientific analysis is open to severe criticism? There are three distinct phases in the development of the attitude of men toward any public function. At first, when the function is new, they do not recognize the existence of any common benefit. The charge made — that is, the revenue collected — is governed by the consideration of the special benefit, just as in the case of a private enterprise. Later, men awaken to the fact that this activity, instead of benefiting special individuals alone, benefits society as a whole; and they remove a part of the special charge, collecting the balance of the revenues needed to carry on the function in some other way. Still later, they cease to regard the special benefit as a proper measure of any special charge, but rather collect the whole of the money needed in some other way — usually by a general levy on the resources of the whole of society. This development may be traced in the charges made for almost all of the functions now performed by the state, where it was possible to conceive of beginning with a price. Such is, for example, the history of the revenues for maintaining the courts,<sup>1</sup> roads, canals, educational institutions and the administrative supervision of industry and commerce. Moreover, in spite of the comparatively recent growth of large cities and the newness of many municipal enterprises, the charges for services rendered by such enterprises already show

<sup>1</sup> As Bastable correctly shows, 2d ed., pp. 72, 73.

the same tendency. In short, in every case where it is possible in the beginning to assume that there is a special benefit conferred, the special benefit is at first made the ground for a special charge. As time goes on, however, that special charge is lessened and finally removed. Professor Bastable himself recognizes and decries this tendency, and uses it as an argument against state ownership of industrial enterprises.<sup>1</sup> Whatever we may think of the desirability of such a development, still the fact remains. Governments do from time to time assume new functions; and when they do, these functions all become subject to the same tendency in development. Scientific analysis must take cognizance of each step in the evolution. The difficulties encountered by the courts in deciding upon the validity of the Wright irrigation act in California are illustrative of the difference in the attitude of men toward old and new functions. The decision of the lower court was practically that the cost of performing this new function (irrigation) must be borne solely by those benefited. This is essentially the attitude usually assumed toward all new functions. But the decision of the supreme court, reversing that of the lower court, passes over any preliminary period, and makes this function at once of sufficient common benefit to justify the collection of charges not measured by the particular benefit.<sup>2</sup>

Not only can it be proved that this development has actually taken place, and that all of these different sorts of revenues are present to-day, as Professor Seligman so well shows, but it can be shown that the tendency to the same development will necessarily appear in the case of every new function, on account of the character which these functions assume in public hands. If any new function or industrial enterprise, when first assumed by the government, is not already a monopoly, it soon becomes one. The same reasons of public policy which led the government to enter upon the new field necessitate the reservation of the whole field as soon as the government is able to fill it.

<sup>1</sup> See p. 190.

<sup>2</sup> In this brief illustration nothing is considered but the question of taxation. The case also involved intricate questions as to the ability of the legislature to create new districts endowed with legislative and taxing power.

The principles which govern the adjustment of charges in the case of monopolies are more akin to those of taxation than are those governing competing enterprises. The transition from charges fixed by "what the traffic will bear" to taxes is easy. To take a concrete example, let us suppose that a city sets up an electric-lighting plant. At first it may submit to the competition of private companies or divide the field with them. But sooner or later it will regard this competition as an infringement upon public rights and will abolish it. A private corporation, other things being equal, cannot compete with the state, for the fact that the government can, if necessary, supply any deficit by taxation makes it an unconquerable competitor.<sup>1</sup> Having acquired the monopoly, there is no other way of regulating the rates than by distributing the total costs according to the well-known principle of "charging what the traffic will bear." The plant in question passed into public hands in order to bring about lower rates or better service, and that very purpose brings the revenues down to costs. In estimating the costs there is, as Professor Bastable himself shows,<sup>2</sup> a natural tendency for public officers to ignore certain elements which a private person would recognize as important. Thus, interest upon public moneys actually invested, but not represented by outstanding bonds, is generally ignored.<sup>3</sup> The charge thus made, being below cost, is what we call a fee. As Professor Seligman shows, such a charge differs materially from a tax, for there is a definite counter-service. It differs from a price in that it is permanently set below cost. It is not an "economic receipt," as Professor Bastable would call it, because it is not governed by ordinary economic principles. Further, to call by the name "casual revenues" a category of public income which is so large, and which renders possible some of the most important new functions now per-

<sup>1</sup> Cf. Hadley, *Yale Review*, February, 1896, pp. 399, 400.

<sup>2</sup> See p. 212.

<sup>3</sup> My attention was recently directed to one case, that of the city of Alameda, California, where the allowance made for the cost of the street-lighting system, paid from general taxes, is so large that the charges for house lighting are very much below cost.

formed by states and municipalities, is to belittle the importance of these revenues; for this name denies that they have any peculiar common characteristics.

A proposal to free consumers from such special burdens by adding all the costs to the general taxes will not yet be seriously entertained. But if such a proposition were made, it would not seem more unreasonable to the citizen of to-day than the present method of paying all the costs of building and maintaining roads at the general expense must have seemed to the citizen at the time when the roads were first taken out of the hands of turnpike trusts and companies. The tendency to change from the fee principle to the tax principle has a further justification. As soon as these enterprises become monopolies in public hands, the principle of adjusting the charges among the different users is that known as "charging what the traffic will bear" — a principle nearly akin to that by which taxes are distributed. According to this well-known principle, which underlies the classification of goods by railroad companies in fixing freight rates and of mail matter in fixing postal charges,<sup>1</sup> a burden is practically distributed among those who are to bear it in accordance with their abilities, which may be indicated in various ways. It must not be forgotten that the very reason for the maintenance of this principle is that, by virtue of reducing the charges made upon those of the least ability, the charge to those of most ability is less than the cost of the service to them would be if a uniform charge were made which those of less ability would be unable to meet.<sup>2</sup>

The feasibility of fixing the tariff of rates according to the costs of the particular services becomes less as the proportion of the costs consumed by the fixed charges grows larger. For example, in the case of a monopoly furnishing the water supply of a city almost all costs (provided the supply be adequate) are

<sup>1</sup> See Hadley, *Railroad Transportation*, ch. vi; Seligman, "Railway Tariffs and the Interstate Commerce Law," *POLITICAL SCIENCE QUARTERLY*, vol. ii, nos. 2 and 3.

<sup>2</sup> It would seem that a justification of progressive taxation might be developed from this principle.



fixed. The costs to the monopoly consist of: (1) interest on the purchase price of the supply; (2) interest on the cost of the reservoirs, both collecting and distributing, of the mains and distributing pipes and, if needed, of the pumping-stations and engines; (3) repairs. In the case of a pumping system there is a small item of cost which varies somewhat with the consumption; but in the case of a gravity system no item — except, perhaps, that of wages for clerical hire — varies with the consumption. In the case of water rates, then, there is no necessary connection between the amount consumed and the charge; and rates can be justly fixed only by an apportionment which disregards the exact amount consumed and recognizes some measure of the relative ability of the various consumers. It costs the monopoly no more to furnish one man with five hundred gallons a day than it does to furnish another with four hundred gallons. If the consumers increase fifty per cent, but are supplied from mains already constructed, the costs certainly do not increase five per cent, and the classified rates may be reduced nearly one-half. Each person benefited by the system should be made to pay on a different basis from that by which he pays for (say) milk, where the cost varies almost directly with the amount consumed. Practically the costs should be distributed among the various users according to some test of their respective abilities. This is, then, very much like a special tax upon a certain class of persons; and if the monopoly is in public hands, it is a simple step from a special to a general tax.

It seems, therefore, that the three stages represented by prices, fees and taxes are historical facts, and must in the nature of things be found in every case where, at the outset, a price is possible. Of course the government may assume new duties in line with the older functions, without at first charging a price. In that case one or more stages may be passed over. The three main features of Professor Seligman's classification are, however, established.

But how about special assessments? Do they form a class coördinate with fees and taxes? Do they form a necessary

step in the evolution of public revenues? Does history show that the charges for any functions pass from fees through special assessments to taxes, or from prices through special assessments to fees? Or do these charges not stand, as do all other fees, between prices and taxes?

It seems incontestable that special assessments are simply one kind of fees. To be sure, they form an independent class of fees, but they are logically fees. Professor Seligman, after admitting that they might be so classified, urges, as the main reason for distinguishing them from fees, that they are of so much importance—in the United States, at least—that they are worthy of special prominence in the classification. This abandonment of the strict logic of the analysis for the sake of calling attention to a special category is as open to criticism as Professor Bastable's refusal to recognize a scientific classification.

In pointing out "in what respects special assessments differ from fees," Professor Seligman says: "In the first place, special assessments are levied only for specific local improvements; fees may be levied for any services."<sup>1</sup> But any one fee is levied only for one service: the field of operation of any one fee is always restricted.

"Secondly, special assessments are paid once and for all; fees are paid periodically according to each successive service." But a great many other fees as well as special assessments are paid once and for all. So far as a particular case is concerned, all court fees are so paid. The special assessment is paid for a particular improvement; if another be made, another assessment is laid.

"Thirdly, a fee is levied on an individual as such; a special assessment is levied on an individual as a member of a class." But even if there are no other fees assessed upon a class (which is not true), this is at best a characteristic showing a difference in species, but not a difference in genus. It is a reason for making this a special class of fees, but not for separating it from fees.

<sup>1</sup> *Essays in Taxation*, pp. 289, 290.

“Fourthly, a special assessment must always involve a benefit to real estate; a fee is paid for a service which may benefit other elements than real estate, such as personal property, or other attributes of the individual without any reference to property.” This is simply begging the question, for the very wording admits that some fees may benefit real estate only — for example, the fee for recording titles to land.

There is, then, no good reason for raising special assessments to the same plane as the other three great natural classes. There is between fees and special assessments no such clear line of distinction as there is between fees and taxes, or between prices and fees. Although special assessments differ from other fees, they do not differ sufficiently to warrant putting them into a special category.

Professor Schwab, in reviewing<sup>1</sup> *An Introduction to Public Finance*, by the present writer, criticises the subordination of special assessments to fees on the ground that the former “offer the only cases in which the ‘benefit theory’ is applicable.” This sweeping statement hardly holds true, for it is the very essence of every price and of every fee that the charge is made upon the person specially benefited. Benefit is always the justification of the tax or of any public charge; but benefit is the exact measure of the charge only in the case of prices, the partial measure in the case of fees, and ceases to be a just or feasible measure in the case of taxes.<sup>2</sup>

In the main — that is, with the exception of his treatment of special assessments — Professor Seligman’s classification seems to stand; and it is extremely desirable that it should be widely accepted and applied. It reveals the essential characteristics of public revenues, and in its general usefulness resembles the well-worn division of individual economic receipts into rent, interest and wages. There is, moreover, another peculiar advantage in adopting this classification. What we have obtained is more than a mere classification of revenues: it is an analysis

<sup>1</sup> *Yale Review*, November, 1896, p. 339.

<sup>2</sup> In the opinion of the writer the distinction between the justification of any charge and the measure of that charge cannot be too often restated.

of all the fiscal activities of the state. Hence it applies to every part of the science of public finance — to public expenditures, to fiscal administration and partly even to public debts.

Public expenditures fall so easily into the same three classes that it is sufficient merely to state them: (1) those which are regarded as conferring only special benefit on the individual, and are undertaken solely in his interest; (2) those which are regarded as conferring a measurable special benefit on the individual, but which at the same time benefit all society; (3) those which are regarded as conferring only common benefit, or special benefit treated as such.

The activities of the fiscal administrative bureaus fall naturally into place in the same way.

The application of this principle to the analysis of public debts, while equally simple and logical, requires more explanation. The analysis of public debts should reveal the kind of credit upon which each important category rests. Public credit, far more than private credit, is dependent upon the trust the would-be lender reposes in the ability and willingness of the debtor (state) to pay. Such ability and willingness are attested by the relation between the creditor's claim and the revenues. In the case of those debts which create a direct claim upon specified revenues the classification will simply follow that of the revenue in question. The only difficulty arises when the claim is not upon specified revenues, but upon all revenues. Here it may be necessary to follow some other principle. Possibly the best method will be to divide these debts according to the nature of the promises — that is, whether for principal only, or for principal and interest, or for interest only. This is the only case to which the proposed system of analysis is found to be inapplicable.

The fact that Professor Seligman's classification of public revenues is based upon a principle which can be logically applied to the analysis of all parts of the science of public finance is further confirmation of its correctness and usefulness. This strengthens the hope that it may be very generally adopted.